

Lastly, the **benefit paid per enrollee** measures the average value of Medicare services provided for each enrollee. <sup>15/</sup> This ratio serves as a benchmark to measure significant changes in the level of payments to beneficiaries among contractors or across several years for a specific contractor. Changes in the ratio may reflect many factors outside the contractor's control, or they may reflect variation in the allocation of resources to activities to establish the medical necessity and medical appropriateness (prepayment utilization review) for claims and to prevent practices by providers that are excessive or abuse the Medicare system (postpayment utilization review). <sup>16/</sup> Some analysts are concerned that apprehensions about Medicare competitive bidding may have acted as an incentive for all contractors to cut benefit safeguards to avoid competition for their contracts and that, if competition were implemented, carriers would attempt to find ways to lower these activities even further.

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15. This ratio is defined as the total dollar value of benefit payments for a year divided by the number of beneficiaries in the same geographic area.

16. Differences among contractors may reflect differences in reasonable and customary charges among areas, differences in medical practice affecting the number of medical visits and claims for a population, seasonal variations affecting the regional incidence of illness, greater preventive practice, or other factors contractors cannot control.

Stringent benefit safeguard activities require staff time and resources and delay payment because of the time necessary to review and verify manually the medical appropriateness of a claim.



### Potential Effects

A competitive system to select contractors based on key performance indicators might provide one mechanism to improve overall contractor performance. Through the elimination of poor performers and subsequent replacement with good performers, the quality of services might be improved.

In order to ensure adequate performance on timeliness, payment-deductible error rate, and other key measures, demonstrations of fixed-price contracts have included financial sanctions (for example, liquidated damages) that reduce contractor reimbursement when performance fails to meet specified standards. These financial sanctions create incentives for contractors to maintain consistent and quality performance. Under the current system, contractors are chastised for poor performance through the routine publication of contractor performance data, but are not directly financially liable for their performance.

Although intended to improve performance, competition might actually create selection and implementation difficulties that would adversely affect contractor performance. First, HCFA might have difficulty in specifying important criteria for consideration. Actual contractor performance might involve programmatic intangibles that might be difficult to describe objectively in the solicitation or to evaluate technically from the



bidder's proposal. These intangibles include important aspects of service delivery such as beneficiary and professional relations, appropriateness of correspondence, and for HI contractors, the adequacy and thoroughness of hospital audits.

Second, an emphasis on cost in the selection criteria might inadvertently affect program performance. If cost was the single most important consideration for selection, bidders might be forced to bid low and thereby lessen the possibility of good performance during program implementation.

The emphasis on administrative cost in the selection criteria might be especially important for the measure of benefit paid per enrollee. The selection of low-cost contractors to replace those who have historically demonstrated high administrative costs may inadvertently eliminate contractors with more benefit-safeguard activities, thereby producing an unintended increase in benefit payments, which could far outweigh any savings in administrative costs.

Third, performance might suffer during transitions. A new contractor with no Medicare administrative experience or an existing contractor in a new area might undergo a period of adjustment or difficulty when implementing the systems required to perform the contract's responsibilities.



Fourth, although financial sanctions have been instituted to ensure adequate performance as measured by certain criteria, the assessment of competitive contractors' performances on safeguard activities, like those under the cost-reimbursement system, focuses primarily on the existence of the activity, or process, rather than its effectiveness. This system may be insufficient to ensure that contractors implement the most effective and extensive activities to limit payments to those intended by law. In particular, the periodic replacement of HI contractors under a competitively awarded system could have serious, although unexplored, consequences for the continuity of staff, the quality of audits, and ultimately the level of HI benefits that are paid. Audits would probably be performed by inexperienced auditors—a responsibility requiring one to two years of supervision and training before independent audits can be performed. This function is of special importance in view of the increasing sophistication of hospitals in realizing the maximum reimbursements from Medicare.

#### Actual Experience

In the competitive demonstrations to date, fixed-price contractors initially have experienced a difficult period after assuming Medicare responsibilities, but then have achieved performances at least as good as those of the previous incumbents, as measured by the criteria described above. 18/

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18. Note that the information in this report only covers the period through April 1983.





Average Processing Time. The four fixed-price SMI contractors demonstrated somewhat mixed success in providing benefits in a timely fashion. Two contractors (Maine I and New York) provided benefits as quickly as the incumbent contractor within one quarter after taking responsibility. The Illinois contractor, however, required five quarters to match the incumbent; and, after three quarters, the Maine II contractor has not met these standards as of the last reporting period--the third quarter of 1982 (see Table 4). Fixed-price contractors that experienced difficulty during the initial year reported that they required more than twice the national average number of days to process a claim.

TABLE 4. AVERAGE PROCESSING TIME OF FIXED-PRICE SMI CONTRACTORS

Area	Number of Quarters to Equal Incumbent Contractor	Number of Quarters to Equal National Average
Maine I	1	1
Maine II <u>a/</u>	4 or more <u>b/</u>	4 or more <u>b/</u>
New York	1 <u>c/</u>	1
Illinois	5 <u>c/</u>	5

- a. The Maine I fixed-price contractor was awarded a second fixed-price contract in the recompetition of the Maine II contract and the continuity of staff and operations was maintained.
- b. Contractor has not equalled incumbent or national average as of the third quarter of 1982.
- c. Compared to the weighted average for incumbents.



The initial period of disruption suffered by the worst performer, Illinois, produced considerable difficulties for the beneficiaries, public officials, and the contractor. Beneficiary reaction prompted an investigation by the Subcommittee on Health of the House Ways and Means Committee. The contractor was forced to devote scarce top level management resources for public relations activities, responses to Congressional inquiry, and other time-consuming activities to respond to the public and to appease critics.

While the difficulties in maintaining processing times may be attributable, in part, to aspects peculiar to the inexperience of HCFA and the contractors in managing a transition, it seems likely that a new contractor can expect some temporary disruption of service while hiring and training a new staff. 19/

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19. The initial slow processing times in the demonstrations were created partly by the large numbers of backlogged claims inherited from the incumbent, complicated revisions and integration of disparate provider codes inherited from multiple cost-reimbursement incumbents when contractor areas were consolidated, insufficient testing of modified systems prior to their implementation, and differences in levels of reimbursement based on new reimbursement codes prompting beneficiary requests for appeals.

In some of the earlier demonstrations, considerable change in contractor operations or revisions in computer systems was implemented; in later demonstrations, minimal change was introduced at the point of transition and desired changes were phased in over the period of the contract. This "phase-in" policy might reduce the duration and intensity of the demonstration project difficulties. In spite of this change, however, some difficulty is expected as contractors experience low productivity and poor performance during the transition period.



After completing this transition period where low performance was experienced, however, fixed-price contractors have repeatedly demonstrated superior performance relative to the national average. In fiscal year 1982, the three fixed-price carriers reported an average processing time of 9.4 days; the national average for all carriers was 10.4 days.

Payment-Deductible Error Rates. Fixed-price SMI contractors also required considerable periods of time to match incumbent payment-deductible error rates. In all cases, more than one year elapsed before contractor performance equalled the incumbent; in two cases--Maine I and Illinois--more than two years passed (see Table 5).

Fixed-price contractor error rates were 70 percent higher than incumbent rates over the period of the demonstration, and rates in the first year more than doubled incumbent rates. Compared to national averages, however, payment deductible error rates for fixed-price contractors equalled the average for cost-reimbursement contractors in the July 1981 to June 1982 period. The projected performance of incumbents was considerably below that level.



TABLE 5. PAYMENT DEDUCTIBLE ERROR RATE OF FIXED-PRICE SMI CONTRACTORS

Area	Number of Quarters to Equal Incumbent Contractor	Number of Quarters to Equal National Average
Maine I	11	2
Maine II <u>a/</u>	6	0
New York	4 <u>b/</u>	3
Illinois	10 <u>b/</u>	11

- a. The Maine I fixed-price contractor was awarded a second fixed-price contract in the recompetition of the Maine II contract and the continuity of staff and operations was maintained.
- b. Based on weighted average of incumbents during last quarter of cost-reimbursement contract.

Benefits Paid Per Enrollee. Although overall performance on the benefit per enrollee measure matched the projected growth over the demonstration period, the performance by individual contractors varied considerably. In New York, benefits per enrollee were more than 20 percent lower than expected; in Maine, payments were equal to projections; in Illinois, payments were 20 percent higher than projected.

Several explanations exist for the change in the average payment under demonstration contractors. First, because of the consolidation of





territories, the implementation of the demonstration contract required a recomputation of rates of reimbursement based on the integration into one rate of the reimbursement coding systems for several cost-reimbursement contractors. The reasonable and customary charges may have been unavoidably adjusted upward or downward because of this recomputation and thus have affected the cumulative benefit payments.

Second, this growth may reflect routine fluctuations in annual payments among contractors. Historic contractor data suggest some variation in the measure by individual contractors across several years.

Conversely, the replacement of high cost contractors with less expensive fixed-price contractors may reflect the allocation of fewer resources to benefit-safeguard activities by fixed-price contractors. Because these contractors do not submit expenditures for specific administrative functions, a direct determination of resource allocation is not possible.

Unfortunately, these demonstration data do not adequately resolve the concern that fixed-price contractors might be encouraged to reduce the resources allocated to benefit-safeguard activities, thereby increasing expenditures for benefits. To mitigate such an effect, HCFA could implement the competitive fixed-price contract with strict contractual provisions and sufficient levels of monitoring to ensure the required use of cost-effective benefit-safeguard activities by contractors.



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## CHAPTER IV. PROGRAM ALTERNATIVES

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This chapter analyzes three alternative methods of awarding Medicare administrative contracts. Each would award administrative contracts based on competitive processes rather than on the nominations of contractors by provider communities. Two options would use a fixed-price contract; the other would maintain a cost-reimbursement arrangement and emphasize potential performance in the selection process. The three alternatives are:

- o Alternative A--competition in the award of all contracts, with fixed-price reimbursement.
- o Alternative B--competition limited to replacement of administratively costly contractors, with fixed-price reimbursement.
- o Alternative C--competition to replace contractors performing poorly in benefit-safeguard activities, with cost reimbursement.

Under each option, selection of contractors would be based on three criteria: technical merit, experience, and cost. The projected cost of the current system (the baseline) is provided in Table 6.

Each alternative is examined by using the following criteria:

- o The administrative cost for contractor services,



- o The level of payments for benefits, 1/ and
- o The timely execution of administrative functions.

TABLE 6. PROJECTED SMI BASELINE OUTLAYS FOR FISCAL YEARS 1984-1988 (In millions of dollars)

Costs	1984	1985	1986	1987	1988	1984-1988 Total
Administration	530	560	590	630	660	2,970
Benefits						
Paid						
Correctly	20,080	23,220	26,810	31,130	36,090	133,330
Net Paid						
in Error	<u>80</u>	<u>90</u>	<u>100</u>	<u>110</u>	<u>120</u>	<u>500</u>
Total Outlays	20,690	23,870	27,500	31,860	36,880	140,800

SOURCE: Preliminary CBO estimates from SMI administrative data.

NOTE: Details may not add to totals because of rounding.

To minimize difficulties during transitions between contractors, it is assumed that any alternative to the current system requiring the transfer of responsibility from one contractor to another would be implemented in

1. Because neither the existing system nor the proposed alternatives put the contractor at financial risk for the level of expenditures for benefits, this discussion will focus on the limited, incremental improvements that might be realized through the selection of contractors who have performed well on benefit-safeguard activities.



conjunction with uniform processing, billing, diagnostic, and provider identification codes. 2/

The estimated effects of competition in this chapter are limited to SMI contractors. HI demonstration projects have not yet provided sufficient data to permit an assessment of the impact of competition on their administrative costs and, more importantly, on contractors' performance.

#### COMPETITION IN THE AWARD OF ALL CONTRACTS, WITH FIXED-PRICE REIMBURSEMENT

This alternative would modify the existing legislative authority to require that all Medicare contracts be awarded through competitive bidding. Contractors would be reimbursed at a rate determined when the contract was awarded, based on a fixed price for a designated period of time or for some predefined unit of work. The selection criteria would emphasize the cost proposed by the bidder; technical merit and contractor experience would be included to exclude poor performers. The transition to a completely competitive system would occur over four years beginning with fiscal year 1984. One quarter of the contracts would be subject to competition each year; contracts that currently have the highest unit costs

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2. Differences in these basic administrative procedures reflect contractors' preferences. These differences are costly and burdensome at the time of the transition because providers must modify their systems to accommodate these changes. Differences between systems also limit the collection of meaningful utilization and cost data in the Medicare program.





would be offered first for competitive bidding. Because of the emphasis on administrative cost control, CBO has assumed that winning contractors would devote fewer resources to preventing errors in benefit payments, thus raising federal benefit costs.

This alternative would increase overall Medicare outlays by \$40 million in fiscal year 1984 and by \$660 million between fiscal years 1984 and 1988 (see Table 7). The cost increases would reflect both higher administrative costs and more benefits paid in error. By introducing the greatest change into the program, this option would also expand HCFA's administrative responsibilities significantly. Fourteen SMI contracts would be awarded each year. 3/

Impact on Administrative Costs. This alternative would increase administrative costs by \$40 million in fiscal year 1984; total additional costs through fiscal year 1988 would be \$270 million. This additional cost would represent a 9 percent increase over projected administrative costs under current policy.

Higher administrative costs are expected to result from a small number of bidders. As experienced in the demonstration projects, the

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3. One option to reduce this number of competitions would be to consolidate the responsibilities of groups of contractors and gradually reduce the number of contracts.



TABLE 7. BUDGETARY IMPACT OF UNIVERSAL APPLICATION OF  
COMPETITION IN SMI, WITH FIXED-PRICE  
REIMBURSEMENT, FISCAL YEARS 1984-1988  
(Changes to the baseline, in millions of dollars)

	1984	1985	1986	1987	1988	Total
Administration	40	20	70	80	60	270
Benefit Payments	<u>0</u>	<u>40</u>	<u>70</u>	<u>110</u>	<u>170</u>	<u>390</u>
Net Budget Impact	40	70	130	190	230	660

NOTES: Positive signs denote an increase in expenditures compared to the baseline presented in Table 6. Details may not add to totals because of rounding.

cumulative effect of competition without sufficient bidders would be an increase rather than a decrease in administrative costs. To apply competition universally, as proposed under this alternative, would require 14 competitions per year--a number far exceeding any observable interest in competition by potential contractors in the recent demonstrations.

In essence, some savings could be achieved in those areas where current contractors have high costs, but these would be offset by increased costs for those operations that are currently performing efficiently and effectively.



Impact on Benefit Payments. Benefit payments would rise because of an increase in the dollar value of payments made in error. Erroneous payments would increase almost 80 percent between 1984 and 1988 compared with current policy. The net impact of overpayments and underpayments would be to increase the program's cost by nearly \$400 million over the period.

Of all alternatives presented, the universal application of competition is most subject to concern about the allocation of resources for benefit-safeguard activities. The universal conversion of the system to fixed-price contracts would tax the abilities of HCFA to monitor contracts and to oversee the activities of the new contractors. Without sufficient monitoring, contractors could easily reduce benefit-safeguard activities, thereby increasing benefit payments.

Impact on Timeliness of Benefit Payments. Contractors would experience, on average, three quarters during which performance would be adversely affected because of difficulties inherent to the transition.

COMPETITION LIMITED TO REPLACEMENT OF ADMINISTRATIVELY  
COSTLY CONTRACTORS, WITH FIXED-PRICE REIMBURSEMENT

This alternative differs from the first in that competition would be limited to areas where contractors have consistently had high administrative costs. The transition would begin in fiscal year 1984 and, over the next four



years, one-fourth of the contractors in the quartile with highest 1983 administrative costs would be replaced each year.

The selective application of competition would represent an incremental change from the existing system. If this approach was found to increase administrative costs or benefit payments based on the experience of the initial years, the policy could be discontinued or curtailed. Its incremental nature is, in fact, a major advantage of this option, because of the uncertainty about the long-term impact of competition on administrative cost, benefit payments, and administrative performance. A gradual transition to this system might also prove to be a more manageable task for HCFA in monitoring transition and operational activities.

This option would increase net outlays by \$120 million over the period 1984 to 1988 (see Table 8). Although it would reduce administrative costs by \$30 million, payments made in error would increase by \$150 million.

Impact on Administrative Costs. By limiting the situations in which competition would be employed, this option would differ from the first alternative in several ways. First, the possible loss of territory through competition could stimulate more cost-efficient management among all incumbents.





**TABLE 8. BUDGETARY IMPACT OF LIMITED COMPETITION  
IN SMI, WITH FIXED-PRICE REIMBURSEMENT,  
FISCAL YEARS 1984-1988**  
(Changes to the baseline, in millions of dollars)

	1984	1985	1986	1987	1988	Total
Administration	20	0	0	-10	-40	-30
Benefit Payments	<u>0</u>	<u>10</u>	<u>20</u>	<u>50</u>	<u>70</u>	<u>150</u>
Net Budget Impact	20	10	20	40	40	120

NOTES: Positive sign denotes an increase in expenditures, compared to the baseline presented in Table 6. Details may not add to total because of rounding.

Second, the selective application of competition would reward incumbent contractors for good performance. The opportunity to retain their contracts would encourage effective management strategies, long-term productivity investments, and technological innovations by incumbent contractors.

Third, by limiting the number of competitions, more bids could be expected in each case. Only four competitions would be held annually, if competition were targeted toward the gradual elimination of the lowest quartile of performers. Competent contractors with an interest in expanding territorial responsibility would be more capable of bidding, because their "home" territory would most likely not be subject to competition.



Impact on Benefit Payments. On the other hand, benefit payments would increase because of a higher error rate. The higher rate of benefit payments made in error would increase program expenditures by \$150 million between 1984 and 1988 compared to current policy (see Table 8).

Impact on Timeliness of Benefit Payment. Some temporary disruption in the performance of the competitive, fixed-price reimbursement contractors would occur. Because of the limited number of competitions per year, however, it is possible that HCFA, based on their demonstration experience, would be able adequately to monitor and direct these transition operations.

#### COMPETITION TO REPLACE CONTRACTORS PERFORMING POORLY IN BENEFIT-SAFEGUARD ACTIVITIES, WITH COST REIMBURSEMENT

This alternative would hold competitions to award Medicare administrative contracts to replace poor performers with others that demonstrate superior capabilities. Awards would be based upon ability to improve the accuracy of benefit payments for eligible individuals. The contractor's performance on the payment-deductible error rate or some other measure that would objectively embody this payment-safeguard orientation would serve as the most important criterion for selection, although an assessment of the technical merit of each proposal would also be included. The cost proposal would be assessed to establish the general acceptability, reasonableness, and justification of the expenditures that were identified. As under the current system, however, the contractor would be reimbursed for



the actual cost of performing administrative activities. The net budgetary impact of this proposal would be \$10 million in additional outlays in fiscal year 1984, but \$240 million would be saved over the 1984-1988 period (see Table 9).

TABLE 9. BUDGETARY IMPACT OF COMPETITION TO REPLACE CONTRACTORS PERFORMING POORLY ON BENEFIT-SAFEGUARD ACTIVITIES, WITH COST REIMBURSEMENT, FISCAL YEARS 1984-1988 (Changes to the baseline, in millions of dollars)

	1984	1985	1986	1987	1988	Total
Administration	40	20	30	40	10	130
Benefit Payments	<u>-40</u>	<u>-60</u>	<u>-70</u>	<u>-90</u>	<u>-100</u>	<u>-370</u>
Net Budget Impact	10	-50	-40	-50	-90	-230

NOTES: Positive sign denotes increased expenditures, compared to the baseline presented in Table 6. Details may not add to totals because of rounding.

Impact on Administrative Cost. Administrative costs would increase by \$130 million over the five-year period, but more emphasis on benefit safeguards and a reduction in the error rate would reduce benefit payments made inaccurately by \$370 million (see Table 9).



Increased administrative costs would reflect increased resources for benefit-safeguard activities. Contractors chosen for replacement probably would have low administrative costs because of their previous limited use of resources for benefit safeguard-activities. Their replacements would spend more money on benefit-safeguard activities, resulting in higher administrative costs. In addition, the emphasis on this performance indicator for contractor replacement and contract award might increase the cost of benefit safeguard-activities by all incumbents.

Impact on Benefit Payments. This option would pursue opportunities to reduce expenditures for benefits by eliminating payments for duplicative, medically unnecessary, or medically inappropriate services, or to ineligible persons. Currently, an additional dollar for benefit-safeguard expenditures is estimated to return seven dollars in reduced benefit payments. By basing contractor selection on benefit-safeguard activities and, thereby, removing the financial incentive to minimize these activities, this alternative would cut total outlays for the Medicare program significantly.

Impact on Timeliness of Benefit Payments. Because of the limited number of contracts undergoing competition at any one time, HCFA would probably be able to monitor these contracts successfully. The period of temporary disruption would probably not exceed two or three quarters for each new contractor.

